Financing strategies for inclusive urban development

Moving beyond the traditional application of public finance theory to advance inclusive urban finance practices in the Global South

LOCAL PUBLIC SECTOR ALLIANCE

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Abstract

Rapidly growing urban disparities in the Global South threaten to exclude many people from receiving the benefits of development progress. Particularly in the context of complex urban challenges—including urban congestion, housing affordability, livability, climate change, and/or ensuring social inclusion in conflict contexts—there is an urgent need to attract additional financial resources to meet the infrastructure investment needs of growing urban populations.

The traditional application of public finance theory suggests that a devolved urban finance strategy should focus on (i) pursuing increased local own source revenue mobilization and (ii) identifying ways in which city governments can take on greater levels of debt. This scenario critically relies on the assumption that city residents benefit from urban infrastructure and services and are willing to pay for services that they receive from city governments with local taxes—typically the property tax—functioning as a 'benefits tax' or a 'quasi-user fee' for urban services.

Upon closer examination, however, this traditional public finance scenario is based on a number of underlying assumptions that generally do not hold in Global South cities, where the urban financing crisis is often the direct result of decades of rapid, cumulative urbanization. Without appropriate intergovernmental fiscal interventions by higher-level governments, the decades-long influx of urban in-migrants in many Global South cities has resulted in a vicious cycle of degradation of urban infrastructure, reduced access to urban services, and—as a corollary—the reduced willingness over time of city residents to pay for urban infrastructure and services through property taxes or user fees. This process, in turn, has often resulted in permanent changes in *de facto* functional assignments, weakening the role of cities in the multilevel governance system, and further adding to the downward spiral of weak services, weak capacity, and low own source revenues.

A technically well-designed inclusive and sustainable urban financing strategy (i) requires city governments to levy a mix of own source revenues (such as property taxes and taxes on local business activity) and appropriate non-tax revenues; (ii) requires city governments to be provided with a set of intergovernmental fiscal transfers that minimizes perverse incentives while encouraging inclusive urban services and efficient urban investment choices; and (iii) requires that city governments have access to suitable sources of capital finance, whether in the form of loans, bonds, public-private partnerships (PPPs), or capital grants. The exact nature of the funding and finance mix will most likely differ considerably in different contexts: Global North cities are likely to rely more extensively on own source revenues and subnational borrowing, while revenue-sharing (or piggy-back taxes), non-tax revenues, and intergovernmental transfers (including capital grants) may play a more substantial role in the financing mix of Global South cities.

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Cities are generally understood to be key to global development, as they are engines of economic growth and spaces for social transformation. Yet, in much of the Global South, rapidly growing urban disparities threaten to exclude many people from receiving the benefits of development progress.[1] Particularly in the context of complex urban challenges—such as urban congestion, housing affordability, livability, climate change, and/or ensuring social inclusion in conflict contexts—there is an urgent need to attract additional financial resources to meet the infrastructure investment needs of growing urban populations.

The World Bank, UN agencies, other global development actors, and public finance experts are engaged in knowledge development and knowledge sharing on urban governance and resource mobilization across countries and global regions to identify urban financing strategies that ensure that urban investments are adequately funded and leave no one behind. These discussions typically focus on finding ways to use city-level finance to promote fair urban development, encourage civic participation, and achieve inclusive and sustainable urban renewal.[2]

Financing strategies for inclusive urban development: the conventional wisdom

Although discussions on sustainable urban finance typically touch briefly on all main sources of public and private urban finance, proposed urban financing strategies or policy solutions often place considerable emphasis on two solutions: first, on identifying ways in which city governments can take on greater levels of debt to invest in urban infrastructure through bonds, loans, PPPs, or other financing mechanisms (***i.e., financing***), and second, on pursuing increased local own source revenue mobilization—typically through property taxes, land value, and other local revenue instruments—which is required to repay the increased debt (***i.e., funding***).

There is a strong public finance argument to be made for this devolved approach to urban finance: city residents benefit from urban infrastructure and services and are willing to pay for services

that they receive from city governments, with the property tax functioning as a 'benefits tax' or a 'quasi-user fee' for urban services. To the extent that city governments act like clubs of urban residents, devolved funding of urban infrastructure and services can thus function as an inclusive and efficient approach to urban finance and development. There is a robust public finance literature going back at least 50 years in support of this narrative, including contributions by James Buchanan, Richard Musgrave, Wallace Oates, Charles Tiebout, and other leading public finance economists.

In turn, the need for city government to have access to financing mechanisms is also well explored in the literature, which concludes that, to the extent that urban infrastructure needs to be paid up-front (as the stream of benefits from urban investments is often spread out over years or decades), borrowing can help to resolve the inter-temporal mismatch between the costs and benefits of public sector investments.

With some minor variations, these public finance arguments hold true in many cities in the Global North, where devolved city governments are largely in charge of urban infrastructure and other public services within their jurisdiction. When urban populations are relatively stable and urban poverty rates are low, most urban residents are willing and able to pay local (property) taxes in return for urban infrastructure and services provided by their city government 'club'. At the same time, in the context of effective multilevel governance systems, local government elections and other accountability mechanisms are in place to empower and ensure that city leaders respond to the priorities of their constituents, all but guaranteeing that urban residents receive benefits (in the form of infrastructure and services) from their city government corresponding roughly to the size of their local tax payments.

Urban finance strategies: applying Global North solutions to Global South problems?

The scenario described above is not the typical scenario faced by city leaders and urban residents in the Global South. Particularly in Africa and Asia, the challenge in most cities is not necessarily the ability of established urban residents to remain in a state of equilibrium by providing, funding, or financing a steady level of urban infrastructure and services for themselves through devolved funding and finance mechanisms. Instead, the urban financing crisis in many African and Asian cities is the direct result of decades of rapid and cumulative urbanization.

In many parts of the Global South, in-migrants have been flocking to bigger cities in search of work for decades, placing ever-greater demands on the existing urban infrastructure. For a variety of reasons, in-migrants typically do so without contributing to the city's fiscus in proportion to the additional demands placed on city services and infrastructure. The established urban residents and elected city leaders are frequently unable (and, perhaps, unwilling) to pay for the services and infrastructure needs of these newcomers. Local politicians respond to their political base (established constituents) by keeping city taxes and fees low. Without appropriate

intergovernmental fiscal interventions by higher-level governments, this results in a vicious cycle of degradation of urban infrastructure, reduced access to urban services, and in turn, the reduced willingness over time of established local residents to pay for urban infrastructure and services through property taxes.

A review of historical municipal finance patterns in India (table next page) suggests that its cities were not always grant-dependent. In the 1960s, before India's major post-independence urbanization wave, cities in India served as largely self-financing urban 'clubs' much as their counterparts in the Global North do today. The relative declines in own source revenues occurred only after urbanization caused India's urban population to explode in the later decades of the twentieth century.

In the context of rapid urbanization faced in many cities in the Global South in recent decades, the 'Global North urban finance solution'—pushing for increased reliance on local revenue mobilization from property taxes and other own source revenue, combined with ensuring that cities have access to urban finance—may be the 'right solution to the wrong problem'.

Table : Municipal Revenues by Categories (1960-61, 2007-08 and 2012-13)

(Per cent)

		Municipal Corporations			Municipalities		
		1960-61	2007-08	2012-13	1960-61	2007-08	2012-13
A. Own Sources	Total Taxes	72.7	45.5	40.9	60.9	18.6	14.7
	Non-taxes	16.4	22.2	23.9	23.9	9.3	10.5
	Total Own Sources	89.1	67.6	64.8	84.8	27.9	25.2
B. Other Sources	GoI Transfers		7.0	4.6		8.4	7.3
	Central Finance Commission Transfers		0.8	2.1		5.3	8.8
	State Assignment/Devolution		11.4	12.6		31.2	29
	State Grant-in-aid	10.9	10.4	12.2	15.2	24.2	23.8
	Others		2.7	3.8		3.0	5.8
	Total Other Sources		32.4	35.2		72.1	74.8
C. Total (A+B)		100.0	100.0	100.0	100.0	100.0	100.0

Sources: RBI (2022) based on Zakaria Committee Report (1963) and Mohanty (2016).

Urban functional assignments in different multilevel governance contexts

Rapid demographic changes in urban populations are not the only cause of urban financing challenges in the Global South. While central government actors in many Global South countries have stepped in to prevent the complete collapse of urban infrastructure, some have done so at the expense of democratic city governance.

Rather than providing city governments with funding and financing support through grants-in-aid or other intergovernmental fiscal transfers to address the externalities created by urbanization and in-migration (arguably the correct textbook solution to the public finance problem), in a fair number of Global South countries, Ministries of Urban Development, Ministries of Water, and other central ministries have effectively taken over the implementation of—and now provide for and/or control the direct funding of—many urban services and infrastructure projects that were traditionally under the aegis of city governments themselves.

The *de facto* re-centralization of urban services generally took place through two distinct processes. First, in some countries, Ministry-level spending on urban services simply overtook municipal spending as a result of the central government's advantage in taxation (and its unwillingness to provide discretionary intergovernmental fiscal transfers to city governments). Second, in other cases, the functions of city-level authorities, corporations, or urban service delivery departments providing urban services (e.g., city water utilities, municipal transport companies, and so on)—or in fact, these entities themselves—were legally transferred to the control of higher-level governments. In some countries, national governments have even taken over the authority and responsibility for urban land-use planning and city revenue collection. As a result, many city governments in Africa and Asia are often left with limited power over city planning and urban services (beyond solid waste management) within the borders of their urban jurisdiction.

These dynamics have led to a divergence in urban functional assignments in different multilevel governance contexts: whereas in Global North contexts, city and municipal governments have extensive (*de jure* and *de facto*) powers and functional responsibilities (authority and autonomy) over a wide range of public services and regulatory function, this is not the case in many Global South contexts (see Box 1).[3]

Beyond creating confusion over functional powers and fomenting a tense relationship between different government levels (which are now competing for resources), the *de facto* centralization of urban infrastructure and services to the central government often results in a structural decline of the city government's institutional ability to deliver urban infrastructure and services, further adding to the vicious downward spiral of weak services, weak capacity, and low own source revenues.

Box 1. Urban infrastructure and services in Bengaluru, Karnataka, India

The state house (*Vidhana Soudha*) in Bengaluru or Bangalore—the capital of the State of Karnataka in India—is adorned with the slogan that "Government's work is God's work". One might wish that the City Hall of Bangalore—*Bruhat Bengaluru Mahanagara Palike (BBMP)*; the fourth largest municipal corporation in India—would be adorned with the mantra "the municipal government's work is the people's work". Unfortunately, this is not the case in practice, as many urban services are *de facto* not delivered by the municipal government:

- Primary and secondary education is generally a state function in Karnataka. BBMP has an Education Department that operates a total of 12 primary schools. All other schools in the city are (state) government schools or private schools.
- BBMP has a Health Department that notionally operates 225 urban health clinics and a handful of hospitals. Yet, the municipal health department has fewer than 120 of its own (administrative and clinical) staff in post. All other health staff are employed, seconded, and paid by the state's (deconcentrated) district health administration. The state's Health and Family Welfare Department issued an order in 2022 for 49 Primary Health Centres to be returned to full state control.
- The Bangalore Water Supply and Sewerage Board (BWSSB) was constituted in 1964 by merging the water and sewerage infrastructure previously managed by the City Corporation and the Karnataka Public Works Department. The Board's Chairman and the other seven Members of the Board are appointed by the State Government.
- The Bengaluru City Police, the city's law enforcement agency, works under the jurisdiction of (i.e., is part of) the Karnataka State Police.
- Bangalore's rapid transit system, Namma Metro (*Our Metro*), is owned and operated by Bangalore Metro Rail Corporation Limited (BMRCL)—a joint venture of Government of India and the State Government of Karnataka.
- Public bus transport in Bangalore is provided by the Bangalore Metropolitan Transport Corporation (BMTC), which is wholly owned by the State of Karnataka.
- The Bangalore Development Authority (BDA) is responsible for zoning and regulation of urban land use. Its Board members, Commissioner, and Secretary are all appointed by the State Government.
- The Bangalore Metropolitan Region Development Authority (BMRDA), responsible for metropolitan-level planning, is headed by the Chief Minister of Karnataka as chairman and the Minister for Urban Development as vice-chairman.
- Lalbagh Botanical Garden and Cubbon Park are managed by the Karnataka Horticulture Department under the Karnataka Government Parks (Preservation) Act of 1975.
- In 2022, the Karnataka State Government established the Bengaluru Metropolitan Land Transport Authority (BMLTA), trying to consolidate and coordinate some of the above state authorities. Karnataka's Chief Minister is the chairperson of the newly established authority.

It has been nearly nine years since the last BBMP council elections. These elections, which should occur every five years, were last held in 2015 and were due again in 2020. In the absence of an elected body, the BBMP's authoritative decisions are made by the BBMP Administrator, a senior Indian Administrative Service (IAS) officer appointed by the State Government through the Urban Development Department. The Chief Executive Officer (Chief Commissioner) of the BBMP is also a senior IAS officer appointed by the State Government.

The role of own source revenues in different multilevel governance contexts

The vertical competition over public sector functions and resources, as well as challenges of institutional capacity in managing services and expenditure, are compounded by the commonly held belief that cities can and should generate most—if not all—of their own funding from local property taxes.

Misconception that cities in the Global North are financially self-reliant. In most countries, even in the Global North, the idea that cities are (or even should be) financially self-reliant is simply false: intergovernmental fiscal transfers play an important role in subnational finances, even in some of the world's largest and wealthiest cities. This is true for a variety of reasons, including the fact that national governments have a tendency to assign themselves (both for technical as well as political economy reasons) control over all high-yielding tax sources. In well-functioning intergovernmental fiscal systems, the primary vertical fiscal gap is universally filled by intergovernmental fiscal transfers.

For instance, despite New York City arguably having the largest local (property) tax base in the world, intergovernmental transfers account for over one-third of New York City's budget. In London, intergovernmental fiscal transfers account for roughly two-thirds of the city government's budget. In Amsterdam, unconditional grants and conditional grants combine to fund close to half of the city budget. Yet not a single global development organization devotes time or resources to increasing local revenue mobilization in New York, London, or Amsterdam. Instead, policymakers in these countries understand that a balanced urban funding strategy requires a mix of own and shared revenue sources along with different types of intergovernmental fiscal transfers.

Despite their advantages, property taxes are extremely unpopular with local voters. Even though property taxes are broadly regarded by public economists as a 'quasi-user fee' for urban services (and thus, an efficient and effective local funding tool), policymakers in the Global North are quite aware of the fact that—among all types of public sector revenue sources—property taxes tend to be the least popular tax instrument. This is true despite the fact that property tax administration in the Global North tends to be reasonably efficient and fairly enforced, and despite property tax payments being relatively invisible and hard to evade (as property taxes are typically included as part of homeowners' monthly mortgage payments). Furthermore, urban property owners in the Global North tend to get relatively high value-for-money from their city governments in terms of urban infrastructure and services in return for their local property tax payments. All these factors notwithstanding, property taxes still tend to be the least popular tax instrument.

In contrast to the Global North—where property tax administration is more or less efficient, where local taxpayers can reasonably expect decent value-for-money in terms of local infrastructure and services, and where non-compliance is generally not an option for most

taxpayers—the context of property taxation in the Global South is often quite different. Given the demographic dynamics and institutional weaknesses that prevail in many cities in the Global South (as noted above), property taxation is unlikely to serve as the benefits tax or quasi-user fee that makes it the conceptually optimal and practical urban funding instrument that it is in the context of many Global North cities.

Cities in the Global South are less likely to become reliant on property taxes. Instead, property taxation in a city with rapid urbanization and major underlying income inequalities is a mechanism for taxing the urban rich (owners or renters of high-value properties) to fund services for the entire city population, including the urban poor. This arrangement is only sustainable to the extent that the city's social contract supports the net fiscal incidence of urban expenditures. The fact that we observe low local tax rates, low collection effort, and low local taxpayer compliance in Global South cities suggests that often the city's social contract does not support an increase in local taxation.

Cities in the Global North often benefit from other local revenues with strong 'tax handles'. A much less explored aspect of urban finance is the fact that many major cities in the Global North are assigned other reasonably high-yielding local revenue sources in addition to property taxes. For instance, major cities in the United States and other OECD countries often rely on revenue-sharing or some type of piggy-back tax (such as a local personal income tax or a local option sales tax, collected by central tax authorities on behalf of the city), some type of business tax or business license fee, and/or significant non-tax revenues where the city has a strong tax handle. For instance, New York City collects a (so-called piggy-back) personal income tax as its main revenue source; the single biggest local own source revenue category in Paris is not the property tax but local business taxes; and Amsterdam collects more in parking fees than it does in property taxes. In each of these contexts, higher-level governments (implicitly or explicitly) gave up some of their fiscal space to improve the vertical fiscal balance in favor of cities and local governments. Giving up fiscal space, however, is not something that Ministries of Finance are typically comfortable with, especially in the Global South.

Local revenue mobilization only results in increased social welfare when local expenditures are efficient and responsive. In much of today's development practice, domestic revenue mobilization—including local revenue mobilization—is assumed to be a good thing, without recognizing that increased (local) revenues only increase social welfare if the generated resources are spent efficiently by the public sector. This may simply not be the case in practice in many countries.

The fiscal federalism literature is more explicit about the need to balance costs and benefits by recognizing that city taxes only increase the well-being of taxpayers or households if city governments spend the additional resources on the taxpayer's spending priorities (rather than on, for instance, redistributive policies that benefit the urban poor). Relatively little attention has been paid in the urban finance literature to the determinants of the 'optimal' level of local taxation—'optimal' as determined or revealed by the choices of voters and elected city government leaders in the real world. It is highly likely that the optimal level of local taxation is

considerably lower than projected by most 'local revenue enhancement studies' in contexts where local tax enforcement powers are weak, local taxpayer compliance is not guaranteed, and where it is unclear whether one dollar (or shilling or rupee) of property taxes translates into one dollar (or shilling or rupee) of better urban services.

There is no doubt that property taxes and other local revenue instruments (such as betterment levies) are—and should be—part of a healthy urban revenue mix, and a balanced urban financing strategy. Yet, it is likely that demographic trends in fast-growing urban areas, unclear or ineffective *de facto* functional assignments, weakly empowered (and weakly accountable) urban governance institutions, higher-level political pressure to keep tax rates low, weak local administrative capacity and lack of transparency, poor local service delivery, and inefficient, inconsistent, and burdensome local tax administration all undermine the Wicksellian link between local revenues (costs) and local expenditures (benefits), thereby weakening the efficacy of property taxation and its role as an optimal funding instrument—as a benefits tax or quasi-user fee—for urban infrastructure and services.

The role of intergovernmental fiscal transfers in different multilevel governance contexts

In the pursuit of financing strategies for SDG localization and inclusive cities, one class of fiscal instruments is seldom discussed: intergovernmental fiscal transfers. While global development actors (rightly) support programs that support "Tax for SDGs", there is no equivalent global program on "Intergovernmental transfers for (localized) SDGs".

If there were a global program on "Intergovernmental transfers for SDGs", it would become rapidly clear that intergovernmental fiscal transfers play an important but complex role in a financing strategy to support SDG localization and inclusive cities.

First, and perhaps most apparent, intergovernmental fiscal transfers are the most obvious choice for funding urban development. This is true because central governments universally have a relative advantage in terms of tax collection, while—almost as universally—central governments have a *disadvantage* in terms of coordinating and prioritizing on-the-ground urban infrastructure across the entire national territory.[4] The argument in favor of intergovernmental fiscal transfers is further bolstered in cases where central authorities want to ensure adequate provision of city infrastructure and services for households for whom the ability to contribute to the city government's fiscus is less than the cost of infrastructure and services that they consume.

While the size of volume of intergovernmental fiscal transfers and the horizontal allocation of grant resources (e.g., the use of an allocation formula) often receive the bulk of policymakers' attention, an often-overlooked aspect of intergovernmental fiscal transfer systems and transfer schemes is their impact on the efficiency of urban spending. While many countries do provide city governments with intergovernmental transfers, the nature and mix of intergovernmental fiscal transfer instruments critically determine the extent to which transfers will help or hinder urban

development. Correct: an inappropriate mix of urban transfers can actually *hinder* urban development.

At one extreme, highly conditional, fragmented, and discretionary transfer systems tend to fund urban infrastructure priorities selected by central government politicians or higher government-level officials, without any guarantee that these investments respond to the true needs and priorities of urban residents. As a result, excessively conditional, top-down urban grants—especially when supported by global development partners—are likely to result in a vicious cycle of "build, neglect, re-build". At the other end of the spectrum, reliance on revenue-sharing or unconditional fiscal transfers may increase the likelihood of local elites directing resources toward their own (political or electoral) priorities, rather than local leaders funding pro-poor services or the infrastructure investments needed to achieve long-term inclusive urban development. In other words, getting urban fiscal transfers right is all about getting the right balance.

A related aspect of intergovernmental fiscal transfers as an urban financing instrument is the negative impact of transfers on local revenue collection. Basic economics suggests that if local governments are rational and responsive economic actors, providing intergovernmental fiscal transfers (almost regardless of type) will induce so-called 'income and substitution effects' that reduce the incentive for own source revenue collections. These effects will be made more severe by poor transfer design: the more discretionary the nature of the grants system (i.e., the easier it is for mayors to receive grants based on their connections with higher-level government politicians or officials), the weaker their incentive to collect own source revenues. When urban grant systems are poorly designed, trying to strengthen urban finances by improving local revenue administration is like carrying water up a hill with a slotted spoon on a windy day: pursuing greater revenue effort by itself will not bring the desired result until the slots in the spoon are filled and the spoon is shielded from the wind.

The role of subnational borrowing and debt in different multilevel governance contexts

A seemingly reasonable argument to make is that—as a rule—city governments that *can* borrow *should* be expected to borrow for capital investment purposes, rather than relying on recurrent own revenues or intergovernmental fiscal transfers to fund their city's infrastructure. Local government borrowing—through loans, bonds, subnational development banks, PPPs, or any other financing mechanism—would then free up recurrent public resources (either in the city's own coffers or at the higher-level government) so that the additional fiscal space can be directed toward public services for poorer constituents or poorer localities.

This logic chain applies when there is a well-devolved urban sector along with responsive devolved governance and efficient devolved finances. In the reality of many Global South cities, however, this logic may not hold.

Urban residents in many countries (especially in the Global South) already face the brunt of the central government's tax-collection efforts—with most of these central taxes collecting in urban areas being spent outside the urban jurisdictions where these revenues were collected. Depending on the extent to which urban taxpayers already face a disproportionate central government tax burden or fiscal burden (when considering the net fiscal incidence, central plus local revenues, and expenditures), it may or may not be suitable to add to this burden by expecting city governments to lean even harder on their local taxpayers to borrow and pay for future urban infrastructure needs, at the same time that they fund rural residents for similar infrastructure investments through the intergovernmental transfer system.

In addition, most countries lack an active market for municipal (or subnational) debt, which raises the cost of borrowing for local governments. Depending on the nature of the expected urban infrastructure investments, for instance, it may be just as appropriate (or even more appropriate) for the higher-level government to borrow funds (particularly when concessional finance is available from international financial institutions), and then to on-lend or on-grant these resources (or use some combination of on-lending and on-granting) to fund urban infrastructure investments.

While many cities currently do not engage is borrowing (or access capital finance through different mechanisms) for the purpose of financing urban investments, this does not necessarily mean that they lack access to capital finance: instead, city governments may be making a deliberate choice not to incur debt as a way to fund urban infrastructure. To the extent that local taxpayers and voters do not feel that they receive good value-for-money from their city government, or to the extent that local governments lack the fiscal space to secure and repay loans, the absence of subnational borrowing may actually be evidence that the capital market *is* working. In such contexts, trying to strengthen urban capital financing mechanisms (e.g., by setting up a municipal bond market, establishing a subnational financial intermediary, or by providing loan guarantees) would provide a 'supply fix to a demand problem', and may do little to sustainably improve cities' reliance on urban financing modalities. In many cases, the limited reliance on subnational borrowing is likely to be a symptom of underlying institutional or political economy problems, rather than being the root cause or the actual disease to be cured.

In many Global South cities, the limited reliance on subnational borrowing is often interpreted as reflecting a lack of access to adequate local government financing. Instead, this is often not (or not merely) the case. Similarly, it is often too simplistic to blame the absence of local fiscal space (needed to repay potential local debt) on technical failures in subnational revenue administration or on the inadequate provision of intergovernmental fiscal transfers. Instead, the inefficiency of the entire multilevel governance system and the weak empowerment of local governments as a whole—a situation that is often driven by a confluence of political economy forces—may need to be considered as a root cause of suboptimal urban finance. Ineffective multilevel governance systems tend to result in weakly empowered local governments, weak local accountability, poor value-for-money provided by local governments, and weak incentives for local revenue generation. As a result, cities raise inadequate recurrent revenues and are unable to attract capital finance. Resolving this vicious cycle of weak local governance and weak local government

finance will require a more holistic approach to promoting inclusive governance and sustainable, localized development, which ought to focus on both fiscal as well as non-fiscal aspects of multilevel governance systems and local governance institutions.

Global differences in the nature of urban governance institutions

The discussion above touched on the fact that the multilevel governance relationship between higher-level governments (i.e., central governments or state governments) and local governments are often quite different in Global North and Global South contexts. Ongoing LPSA research is uncovering that the institutional nature of cities and other local governments in the Global North and the Global South are often fundamentally different. Understanding the institutional nature of city governments is incredibly important in determining the right urban financing strategy.

The basic theories underlying decentralization and fiscal federalism assume that local governments have the authority and autonomy to tax, act, and spend in accordance with their constituents' preferences without any interference from higher-level governments. In fact, these conditions are baked into the definition of local governments used by the United Nations, World Bank, IMF, OECD, and others (UN 2008). Yet, in practice, limits on city governments' political, administrative, and fiscal autonomy and authority are all too common in the Global South: for instance, it is not unusual for the real power of city administration to be placed with a chief executive officer appointed by the higher-level government, or for national legislation to require city governments to implement central government priorities, or for cities to have their budgets approved by the Minister of Local Government or national parliament.

While the impulse for such vertical controls may be understandable (given the grant dependency of city governments and/or the weakness of institutional capacity), limits on cities' political, administrative, and fiscal autonomy and authority do not come without a downside. As noted above, limiting the decision-making power of local governments reduces the desire of locally elected leaders to generate more own source revenues, especially to the extent that local politicians are unable to direct the additional resources toward spending priorities that will get them reelected. Instead, other funding sources—such as constituency development funds, discretionary grants, and central government urban infrastructure projects—provide mayors and city leaders with politically more expedient ways to fund local development than taxing their neighbors. Overall, the weaker the ability of local governments to respond to the priorities of their constituents, the harder it is for the people to hold their local government leaders accountable.

At the same time, in different multilevel governance arrangements, less democratic or more weakly empowered urban local governance institutions may actually present *opportunities* for greater urban financing. For instance, if the mayor is a non-elected position and/or if city department heads are seconded from the central government, there may be less resistance from local leaders and administrators to top-down efforts to increase local property tax collections. As such, it is critical to understand the institutional and political economy context of local governance institutions.

Conclusions

While local taxes and non-tax revenues are a critical and necessary part of any urban financing strategy to strengthen cities as platforms of inclusive governance and sustainable urban development, decisions on taxation and public spending are fundamentally political in nature. License plates in Washington, D.C. remind residents and visitors alike that 'taxation without representation' is not a desirable situation.[5] The same concern holds true in countries where city governments are not effectively empowered—politically, administratively, or fiscally—to provide responsive and effective urban infrastructure or services. In the end, taxpayers—whether local taxpayers or central taxpayers—are not well-served when paying more in taxes does not result in better and more responsive public services.

A technically well-designed inclusive and sustainable urban financing strategy (i) requires city governments to levy a mix of own source revenues, such as property taxes and taxes on local business activity, and appropriate non-tax revenues; (ii) requires city governments to be provided with a set of intergovernmental fiscal transfers that minimizes perverse incentives while encouraging inclusive urban services and urban investment choices; and (iii) requires that city governments have access to suitable sources of capital finance, whether in the form of loans, bonds, PPPs, or capital grants.

Neither the extent of local revenue autonomy nor the amount of subnational borrowing should be used as an objective metric for the success of the urban finance system. In some contexts, where a city's underlying demographic, economic, and governance patterns and systems are stable, equal, and responsive, inclusive urban financing strategies can rely more on devolved funding mechanisms and financing modalities such as own source revenues and subnational borrowing. In other contexts, where underlying societal forces are unstable, unequal, and unresponsive, urban financing strategies will more likely have to rely more heavily on carefully designed intergovernmental transfers, including recurrent transfers as well as capital investment grant funding.

Finally, a well-designed and successful urban financing strategy should not only consider the revenue side of the city's budget books, but should make sure that the city government is well-positioned to transform financial inputs—from local taxpayers, from banks or investors, as well as from higher-level governments—into services and infrastructure investments that respond to the interests of all stakeholders in the urban area. The ability to overcome the major urban challenges of the twenty-first century with intergovernmental fiscal tools will be limited as long as subnational governance institutions lack adequate political and administrative autonomy, authority, accountability mechanisms, or the right incentives.

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End Notes

[1] This article uses the terms 'Global North' and 'Global South' to make a general distinction between developed economies or countries (often with devolved public sector structures) and developing countries (often with non-devolved public sector structures and/or less effectively devolved multilevel public sectors). It is recognized that within both the so-called Global North and Global South there are extensive differences in political and economic systems and demographic compositions and trends, precluding the reality of either a monolithic Global North or a monolithic Global South. Research by the Local Public Sector Alliance on the nature of subnational governance institutions shows strong (sub)regional tendencies in multilevel governance systems around the world, while also revealing a degree of (sub)regional diversity in the nature of subnational governance institutions. With notable exceptions, many countries and cities in Africa, Asia, and the MENA region tend to be well-described by the 'Global South scenario' in this article.

[2] See for instance, C40 (2017), Kim (2016) and UN-Habitat (2023).

[3] It is not unusual for city/local governments in OECD countries to be in charge of major public services and urban functions across the full spectrum of government functional categories, ranging from general administration (e.g., civil registration); public order and safety; urban (road) infrastructure, urban markets and regulation / licensing of local business activity, urban transportation and transit; water and sanitation; housing and community amenities (including regulation of urban land use, issuance of building licenses, installation of street lights, etc.); environment protection (green space, parks, solid waste); regulation and provision of local public health and public education services; as well as social protection and 'caring services'.

[4] This vertical organizational argument is generally true in the public sector as well as in the private sector: recognizing their comparative advantage, manufacturers focus on manufacturing and distribution, while leveraging the entrepreneurial role of retailers to identify and serve the needs of their customers and communities. In most cases, it would be highly inefficient for manufacturers to own and operate their entire distribution network down to the retail level in a top-down manner. This, however, is the (political economy) tendency of public sector organizations.

[5] The Government of the District of Columbia (D.C.) uses the phrase because residents of the national capital district are required to pay federal taxes without having representation in the U.S Congress (i.e., no voting member in the U.S House of Representative or U.S. Senate).